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TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER
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SENSITIVE

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SUBJECT: CENTRAL BANK STRENGTHENS CREDIBILITY WITH BOLD RATE HIKE

Ref: A) Ankara 3033; B) Ankara 3104

1.(SBU) Summary: By raising its policy interest rates 1.75% when markets were expecting a much more modest increase, the Turkish Central Bank has taken a step towards restoring some of the credibility it had lost since the appointment of a new Governor and since the global sell-off hit Turkish markets. Higher-than-expected inflation data for two months in a row have substantially altered the inflation outlook for 2006. Unless the market sell-off deepens, the effect on Turkey's debt situation and on the banking sector seems manageable and there is no evidence yet of serious problems in the banking or corporate sectors. End Summary.

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High Inflation Numbers Prompt Extraordinary Central Bank Meeting
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¶2. (SBU) Following the announcement late Friday, June 2, for the second month in a row, of higher-than-expected inflation data, the Central Bank announced it would hold an extraordinary meeting of its interest-rate setting Monetary Policy Committee on Wednesday, June 7. The consumer price index rose 1.9% in May, bringing the increase over the past twelve months to 9.86%, well above 2005 inflation and virtually precluding Turkey will achieve its 5% 2006 inflation target. (Separately, a Central Bank survey released June 8 found that end of year inflation expectations had increased to 8.82%) After the inflation data was announced on June 2, the Central Bank declined for logistical reasons to follow the IMF's counsel to hold its meeting on the weekend to moderate the anticipated market reaction to the inflation news. Between the inflation data and a resumption of selling in global markets, Turkish financial markets resumed their bearish trend: the exchange rate reached 2 lira to the Euro and was over 1.584 lira per dollar on Tuesday, before easing slightly on Wednesday. By Wednesday's close the stock exchange index had fallen 3% from Friday's close. The continued slide on Wednesday came despite Minister Babacan's attempt to put Turkey's situation in perspective by reaffirming the Government's commitment to structural reforms and by trying to get markets to focus on macroeconomic fundamentals. The yield on the benchmark bond, which started the year at 13.85% reached 18.46% on Monday but eased back to 18.03 % at the close on Wednesday.

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Markets Favorably Surprised by Scale of Rate Hike

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¶3. (SBU) After the markets closed on Wednesday, the Bank announced that the MPC had decided to raise rates 1.75%, lifting its borrowing rate from 13.25% to 15% and its lending rate from 16.25 % to 18 %. With analysts having predicted an increase between 50 and 100 basis points, the Bank successfully surprised the markets with the boldness of its move. Market commentary was uniformly positive, marking a 180-degree shift in commentary on the Central Bank. Many analysts believe the Bank has succeeded in getting ahead of the curve, whereas they had been critical both in public and in private conversations over the tepidness of the Central Bank's response to the past month's sell-off. The Bank's accompanying statement suggests that by raising rates so sharply at one go, it hopes it would not have to continue raising rates, though that will depend on future inflation data releases.

Impact Centers on Exchange Rate

¶4. (SBU) The currency market seems to have been the principal beneficiary of the improved mood in the market. The stock exchange continued to sell off on Thursday (down 3.73%), demonstrating that global markets are the principal driver of Turkish markets. Equities were driven down by a powerful bearishness in global markets and the fact that the higher borrowing costs implied by the rate hike are a negative for corporate profits. Likewise, the yield on the benchmark government bond did not improve with the news and closed at 18.03% on Thursday. The exchange rate, however, started to appreciate in night trading Wednesday night after

the Central Bank announcement and did not follow the equity market down on Thursday, ending the day at 1.55 to the dollar at the close of trading.

¶5. (SBU) Before the MPC meeting, some analysts had suggested the Bank might also intervene in foreign exchange markets. By taking no action in foreign exchange markets, the Bank implicitly reaffirmed its stated commitment to the floating exchange rate regime. Yet in his remarks on Thursday Central Bank Governor pointed out that the Bank can always exercise its authority to curb the volatility in the currency market, implying he was leaving the door open to the possibility of intervention. Some analysts believe the Bank may yet intervene to brake the fall in the exchange rate but is waiting until the State Deposit Insurance Fund completes its large sales of foreign exchange from the proceeds of its sales of companies seized from the owners of failed banks, especially Telsim, the cell phone company formerly owned by the Uzan group. The head of the SDIF raised eyebrows in recent days by talking about his large foreign exchange sales, although a Central Bank official told us not to make too much of this, saying SDIF, like all state institutions, had given the Central Bank prior notice.

Striking a Blow for Central Bank Independence

¶6. (SBU) The large increase in rates, in addition to signaling determination to rein in inflationary pressures, is also being interpreting as a reassertion of Central Bank independence. With the selection process of the new Governor having raised concerns about bank independence, Governor Yilmaz seems keen to stand up to the Government. We are hearing rumors of frictions with the Prime Minister. Moreover, in a speech June 8, the Governor called for fiscal policies to be in line with the program - apparently a warning against the Government succumbing to its occasional bouts of fiscal populism. Yilmaz also cited the importance of the IMF and EU anchors to the Turkish economy, a point

the government has chosen to frame in a way that is more in tune with domestic political priorities (emphasizing that it's the Government's - not the IMF's program).

¶7. (SBU) Though Yilmaz' muscle-flexing is encouraging, the Bank has not yet fully recovered its credibility or reputation for independence. The news of the rate hike drowned out a market-unfriendly development at the Bank - the appointment to the Monetary Policy Committee of Bank board member Ibrahim Turhan. When Turhan's name was bruited as a possible Vice-Governor in March, the Turkish press uncovered his anti-free market, anti-IMF writings in an Islamist journal. Yilmaz participated in the June 7 MPC meeting, along with the two recently-appointed, and less controversial new Vice-Governors.

Sell-Off Yet to Impact other Vulnerabilities

¶8. (SBU) The past month's sell off in Turkish markets has yet to show signs of having a serious impact on Turkey's key areas of macroeconomic vulnerability. The fall in the exchange rate came as a welcome relief to the export and tourism sectors, though few economists expect much of a short-run boost to exports. The most recent tourism numbers show the numbers broadly in line with last year's record number of visitors, putting to rest earlier fears of a sharp fall in tourism revenues.

¶9. (SBU) Curtailed inflows of portfolio investment, which would normally raise concerns about financing Turkey's large and growing current account deficit, coincide with very positive news flow on foreign direct investment. With many of last year's mega-deals being paid for in installments, the pre-correction outlook for FDI was at least on a par with last year's strong $ 9.6 billion inflow. Some recent announcements have led the IMF Resrep, for example, to state publicly that FDI could reach $20 billion for the year. In a meeting June 2, Treasury Under Secretary Canakci predicted a similar level and noted that the increase in FDI compensated for the expected increase in the current account deficit.

¶10. (SBU) Canakci also told us he is quite confident about Treasury's debt situation, saying that even if market conditions caused Treasury to only roll over 55 to 60% of maturing debt, Treasury could still finance itself. He also pointed out that the IMF's insistence the Government save any above-projection revenues helps Treasury's cash position, as do strong receipts from privatizations and SDIF asset sales.

¶11. (SBU) Though it may be too early to tell, there is no sign yet that the banking sector has been hurt in any significant way by the sell off. Canakci told us the bank regulatory agency (BRSA) has not reported any problems. The impact on the corporate sector is much less clear, however, since some Turkish corporates have been hurt by the effect of a weaker lira on their large borrowings in foreign exchange.

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